REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

THE CALIFORNIA PUBLIC UTILITIES COMMISSION NEEDS TO IMPROVE ITS RATE REVIEW SYSTEMS

P-219

JUNE 1983

REPORT BY THE

OFFICE OF THE AUDITOR GENERAL

TO THE

JOINT LEGISLATIVE AUDIT COMMITTEE

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June 16, 1983

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Honorable Art Agnos
Chairman, and Members of the
Joint Legislative Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the California Public Utilities Commission's rate review system.

Respectfully submitted,

THOMAS W. HAYES
Auditor General

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SUMMARY

The California Public Utilities Commission (commission) is responsible for ensuring that gas and electricity rates are fair and reasonable and that they reflect the actual costs that utilities incur. To accomplish this objective, the commission analyzes utilities' applications for general rate changes and for fuel cost rate adjustments. Based upon its analyses, the commission approves those increases that are justified. In fiscal year 1981-82, gas and electric utilities filed applications for general rate increases totaling approximately $874 million. The commission granted increases totaling $480 million. In the same year, gas utilities requested fuel cost rate increases of approximately $3 billion and electric utilities requested fuel cost rate increases of approximately $821 million. The commission granted increases totaling $2 billion and $294 million, respectively.

Our review of ten rate change cases that the commission acted on between 1980 and 1982 revealed that commission analyses of rate change requests are sometimes incomplete and inconsistent and that they sometimes involve duplicate efforts by the commission staff. While the commission deletes millions of dollars annually from rate increase applications, it approves some utilities' requests for rate changes without a thorough analysis of all factors that can affect rates.

Incomplete Reviews

In one general rate change case, commission staff did not adequately analyze project costs of additions to plant claimed by the utility. Although the staff reported to the commission that all projects costing over $1 million were analyzed, only 17 of 61 projects were analyzed. The projects that were not analyzed accounted for approximately $150 million (58 percent) of the $258 million total for projects costing over $1 million. For the projects that the staff did analyze, analysts recommended reducing the utility's project costs by more than $37 million.

In two general rate cases we reviewed, the commission staff did not thoroughly analyze expenses claimed by utilities for routine operation and maintenance. In these two cases, the utilities claimed total operation and maintenance expenses of over $3.6 billion. Without thorough analysis of costs for routine operation and maintenance, the commission cannot ensure that utilities' requests for rate increases are not based on inflated expenditures. When staff did analyze these utilities' routine expenses, staff recommended large reductions in the expenses that the utilities claimed. In one instance, staff recommended deleting over $1 million from routine operation and maintenance expenses.

In addition, the commission auditors do not always perform the most important tasks to verify that the financial data that utilities submit on a request for a rate change reflect appropriate information. Consequently, commission engineers may be relying on incorrect data when calculating the utilities' revenue requirements and the necessary rate changes to support those requirements.

Inconsistent Analyses

In one general rate case, commission staff applied an inflation factor to the utility's rate base that was lower than the utility's estimated inflation factor, but the staff failed to apply a reduced inflation factor to another utility's rate base in a similar case. Failure to apply the lower inflation factor in this case resulted in inappropriate additions of at least $8.2 million to this utility's rate base. Based on information provided to us by the commission staff, we estimate that this inappropriate addition could result in overcharges to consumers of up to $1.9 million per year.

In fuel cost adjustment cases for gas utilities in 1982, the commission's auditors audited one gas company but did not audit another in a similar case. Without an audit, the commission cannot ensure that consumers are paying appropriate rates. In the audit that was performed, the staff recommended that the utility's requested revenue be reduced by nearly $102 million.

Inadequate Coordination of Staff

Because managers have not adequately coordinated staff activities, auditors and engineers have performed duplicate efforts in some cases and have neglected to analyze some items in other cases. In three fuel cost adjustment cases for electric utilities, engineers and auditors requested duplicate information from the utilities. Out of a total of 188 data requests made by engineers and auditors to obtain information from the utilities, we found that 60 involved duplicate requests. In another case, staff neglected to analyze three items that the commission considers in deciding the utility's request for a rate change.

Procedural and Staffing Deficiencies

Incomplete and inconsistent commission analyses and inadequate coordination of staff have occurred because the commission lacks written standard procedures to direct staff in reviewing utility requests for rate changes and because some supervisors did not adequately review staff work. The commission also lacks a centralized system for collecting and maintaining data. Finally, the commission may not have sufficient staff to perform all of the tasks it is responsible for. However, the commission cannot determine appropriate staffing levels because it lacks adequate staffing data.

The commission has recently initiated several changes that will address some of the weaknesses we identified. The Utilities Division has developed draft standard procedures to guide engineering staff in reviewing fuel cost adjustment cases and has developed a draft form for utilities to report data on monthly operations and fuel use. Also, in response to the increasing complexity of utility rate cases, the commission reorganized some review functions and added additional staff to expedite its methods of analyzing utilities' requests for rate changes.

Recommendations

To define objectives, establish work priorities, and clarify responsibilities of staff, the commission should develop and follow standard procedures for reviewing requests for rate changes. To provide the data that the commission needs for analyses and forecasts of utility revenue and expenses, the commission should develop a standard form for utilities in submitting their requests for rate changes. To ensure thorough, complete, and consistent analyses of utility

requests for rate changes, the commission should establish and follow management review and quality control procedures. Finally, to establish appropriate staffing levels in all elements of the rate change review, the commission should develop workload staffing data.

INTRODUCTION

The California Public Utilities Commission (commission) is responsible for regulating privately owned public utilities and transportation companies. The commission's objective is to ensure that safe and adequate gas, electric, telephone, water, transportation, and other services are available to consumers at rates that are fair to both the consumers and the companies. Rates must reflect the reasonable costs of a company's operations and include a fair rate of return on a company's investment. The commission regulates the rates and service of more than 1,500 privately owned utilities and transportation companies and over 20,000 commercial highway vehicles.

The commission comprises five members appointed by the Governor and confirmed by the State Senate for staggered six-year terms. Each year, commissioners elect one of their members as president to preside at decision-making conferences and other formal sessions. The commission appoints an executive director responsible for the day-to-day operation of the commission and the direction of over 960 staff, including accountants, engineers, economists, and other professional and support personnel. The commission also appoints a General

Counsel responsible for supervising the commission's attorneys. For fiscal year 1982-83, the commission had a budget of over $38 million.

The responsibilities of the commission are described in Article XII of the California State Constitution and in the Public Utilities Code, Section 201 et seq. These responsibilities include setting utility rates, approving the operations of utilities, and monitoring utilities' operations for safety. The commission also holds hearings to resolve consumers' complaints and to review subjects related to regulating utilities.

Rate Setting Process

One of the commission's major responsibilities is establishing the rates that utilities charge consumers. In establishing utility rates, the commission considers the overall financial picture of the utility, the return on investment needed to attract investors, and the consumer, who is interested in the lowest possible rates. The commission is charged with balancing these interests to ensure that rates are fair and reasonable.

Rate setting involves several groups and processes. First, the utility submits its request for rate changes. The commission staff analyze the utility's request and then present recommendations as evidence at public hearings, over which an administrative law judge presides. The utility, the public, and any other interested party may also present evidence at these hearings. Next, the administrative law judge prepares a decision for consideration by the commissioners. After considering the evidence presented and the judge's recommendation, the commissioners decide how much the utility can adjust its rates. If their decision is contested, the commissioners may grant a rehearing. However, if the commissioners deny a rehearing, only the California Supreme Court can review the commission's decision.

The commission sets utility rates in two major ways: general rate cases and fuel cost adjustment cases. Every two years, the State's four largest privately-owned gas and electric utilities may file with the commission an application for a general rate hearing; the smaller privately-owned utilities may file for general rate hearings more frequently. In general rate cases, which take about a year to complete, the commission looks at the utility's complete financial picture, including the utility's rate base (which includes the utility's buildings, equipment, and other assets devoted to public use), revenues, and operating expenses. Next, the commission

determines the total amount of revenue that will allow the company to collect sufficient funds to meet its operating needs and also provide a reasonable return on its rate base. The utilities are not guaranteed a profit but are allowed to recover approved revenues through prudent management and efficient operations.

The commission also sets rates through fuel cost adjustment cases. These proceedings are designed to enable utilities to keep pace with the fluctuations in the cost of oil, natural gas, and other fuels. Utilities may apply for fuel cost adjustments for rate changes twice a year. Rates are based on the estimated cost of fuel during the year and may be adjusted periodically to reflect cost changes. Each year, the commission staff also assess the reasonableness of utility operations for the previous twelve months to determine whether the company has managed its fuel prudently. Reductions in rates may occur if the commission determines that the utility incurred unreasonable fuel costs.

In fiscal year 1981-82, natural gas and electric utilities filed 12 requests with the commission for general rate case increases totaling approximately $874 million. The commission granted increases of approximately $480 million. Utilities also submitted 25 requests for fuel cost rate adjustments. Natural gas utilities requested rate increases of

approximately $3.0 billion, and the commission granted approximately $2.0 billion. Electric utilities requested rate increases of approximately $821 million; the commission granted increases of approximately $294 million.

Staff Review of Requests for Rate Changes

To ensure that only appropriate rate changes are made and that the new rates are fair and reasonable, the commission assigns to its staff the important role of studying all factors involved in a particular rate adjustment request. The staff review and analyze requests to identify inappropriate or inaccurate data. Staff reviews include audits of the utility's accounting and financial records, estimates or forecasts of revenues and expenses, and assessments of the reasonableness of fuel costs and fuel management practices. Accountants, engineers, and economists in the commission's Revenue Requirements Division and the Utilities Division are primarily responsible for these reviews. The accountants audit the utility's past performance as recorded in its financial records, while the engineers analyze the utility's forecasts of its future operations. The economists prepare revenue and sales projections and study the cost effectiveness of issues such as conservation and alternative energy proposals.

To determine if the data on the rate change request are presented fairly and appropriately by a utility, commission accountants review the financial data of the utility's operations, checking the appropriateness of the cost items to be included in forecasts of future operations, verifying that financial data are included in the proper accounting period and are recorded in the correct accounts, and verifying that the cost of retired or obsolete equipment is removed from the utility's rate base. Commission engineers and analysts then use the audited financial data to develop forecasts of utility revenues and expenses. These forecasts form the basis for estimating the income the utility will need to support its operations in the succeeding two years and then estimate reasonable changes in utility rates.

The staff also produce economic forecasts and conduct studies to determine the estimated life of utility buildings and equipment. The economic forecasts include, for example, estimated growth in the demand for natural gas and electricity and expected increases in inflation. In fuel cost adjustment cases, staff engineers and analysts analyze utility fuel use, fuel costs, and fuel management practices.

Although the accountants, engineers, and analysts may work in different divisions of the commission, for each general rate case or fuel cost adjustment case, they are organized into

a team headed by a project manager. The manager assigns team members to various elements of the analysis, and they conduct their respective reviews and issue separate reports. These reports present recommendations on the appropriateness of the rate changes. They also provide data on fuel cost and fuel management practices, total operating revenues and expenses, taxes, and interest costs.

The staff enter these reports as evidence during hearings and present them along with staff testimony for consideration by the commissioners. The commissioners base their final decision on the record developed during the hearings, taking into account the request of the utility, the recommendations of commission staff, and the testimony of other interested parties. Because the record developed during the hearings is the basis for the commission's final decision, the quality of the staff work is crucial.

SCOPE AND METHODOLOGY

The purpose of our audit was to review the rate setting procedures of the California Public Utilities Commission. We reviewed the effectiveness and efficiency of the commission staff in analyzing gas and electric utility requests for rate changes. We did not review the adequacy of

the hearing process or the activities of the commission's attorneys and the administrative law judges.

We examined commission policies and procedures, interviewed commission staff and managers, and reviewed reports and documents prepared by staff analysts, engineers, and auditors. We also contacted utility commissions in other states to obtain comparative information on rate setting procedures.

To evaluate the effectiveness and efficiency of the commission staff, we reviewed general rate change requests for 1982 and 1983 by the State's largest and third largest investor-owned utilities in terms of gross revenues. The general rate cases we reviewed were for rate changes requested by Pacific Gas and Electric Company and Southern California Gas Company. We also examined portions of other general rate cases. We interviewed staff, evaluated their reports and supporting workpapers, and reviewed relevant commission decisions and orders.

We also reviewed 8 of 13 fuel cost adjustment cases requested in 1982 by the largest utilities regulated by the commission. The 8 fuel cost adjustment cases we reviewed were for two rate changes each requested by two natural gas utilities, Pacific Gas and Electric Company and Southern

California Gas Company, and one rate change for each of four electric utilities, Southern California Edison Company, San Diego Gas and Electric Company, Sierra Pacific Power Company, and Pacific Gas and Electric Company.

CHAPTER I

THE CALIFORNIA PUBLIC UTILITIES COMMISSION NEEDS TO IMPROVE ITS REVIEW OF UTILITY REQUESTS FOR RATE CHANGES

The California Public Utilities Commission needs to improve its systems for monitoring and controlling staff reviews of utility requests for rate changes. Commission staff are not performing thorough analyses of data that utilities submit to justify requests for rate changes. Moreover, staff have not analyzed and audited rate change requests consistently. Furthermore, project managers do not adequately coordinate staff activities, resulting in a duplication of effort in staff reviews of rate change requests.

These problems stem from weaknesses in procedures for controlling and monitoring rate setting reviews. The commission currently lacks policies that define standard procedures, describe rate review objectives, and specify staff responsibilities. Further, because the commission lacks adequate data to determine appropriate staffing levels, the commission may lack adequate staff necessary for reviewing some elements of utility rate change requests. As a result of these problems, the utility rates that the commission establishes may not reflect only those utility costs that are fair and reasonable.

THE COMMISSION STAFF DO NOT PERFORM THOROUGH REVIEWS

The commission's reviews of utility requests for rate changes should be more thorough. Our review of recent rate cases revealed that the commission's engineers and analysts have not conducted adequate analyses of utilities' costs for additions to plant (project costs for newly completed generating plants, dams, transmission lines, gas lines, or major modifications to the utilities' buildings or equipment). In one general rate case, commission staff allowed the utility to add approximately $150 million to its rate base without a thorough staff analysis. Also, the commission's auditors have not always completed important tasks in their audits of the financial data that utilities submit in general rate cases. Furthermore, the staff also did not thoroughly analyze expenses that the utilities claimed for routine operations and maintenance. As a result of these weaknesses, the commission cannot ensure that the data utilities submit to support their request for rate changes are correct. These deficiencies have occurred because the commission has not established standard procedures and analytical approaches that staff should follow in reviewing utility requests for rate changes.

Costs of Additions to Plant and Utilities' Financial Records Not Analyzed Adequately

The commission staff did not perform an adequate analysis of project costs for additions to plant in general rate cases we examined. Also, commission auditors did not thoroughly audit utilities' financial records. As a result of these deficiencies, the commission cannot be assured of the accuracy of the data on which it bases decisions on utility rates.

Additions to Plants

In the two general rate cases we reviewed, the utilities listed project costs for "additions to plant" as a major item to support their requests for rate changes. The two utilities wanted to add to their rate base project costs totaling approximately $635 million. However, we found instances where the commission staff did not perform thorough reviews of project costs claimed by the utilities.

In the Pacific Gas and Electric Company (PG&E) general rate case, for example, the commission staff stated in their report to the commission that they had analyzed all of the utility's additions to plant that cost over $1 million and that they found the costs claimed by the utility to be reasonable. The 61 projects totaled $258 million. In our

review, we considered a project "analyzed" if there was evidence of a systematic analysis of costs, including a visit to the project site. Using this criterion, we found that the staff had analyzed the cost of only 17 of 61 projects costing over $1 million. The 17 projects that the staff analyzed totaled approximately $108 million, only 42 percent of the total cost of the major projects the utility wanted to add to its rate base. As a result, $150 million was added to the utility's rate base without adequate analysis by the commission to ensure that the utility's estimated project costs were incurred prudently.

Among the several large and costly projects that the staff did not analyze in the PG&E case were a $9.4 million dam reconstruction project and a $37 million transmission line system. The staff said they did not analyze the dam reconstruction project because of its remoteness from commission offices and budget restrictions on travel.* A staff engineer told us that he did not analyze several other types of projects in the PG&E case because he believed the utility was proficient at estimating the costs of such projects. However,

* The dam is located near Burney in a remote mountain area in northeast California, accessible only by 4-wheel drive vehicles.

we found that a management consulting firm had previously reported to the commission that PG&E lacked good project cost estimating techniques.

The importance of analyzing project costs is demonstrated by the dollar value of adjustments that the commission staff recommended as a result of their review of the 17 projects in the PG&E rate case. Commission analysts noted that two geothermal power generating plants would not be completed on time. As a result, PG&E reduced its claimed cost for these two projects by $34 million. Moreover, as a result of a visit to a third project, commission analysts recommended a reduction of another $3.5 million in project costs. The analysts discovered that PG&E was rebuilding a portion of a facility instead of building a new facility as the utility had claimed on the rate change request.

The commission's review of the costs for additions to plant claimed by Southern California Gas Company further illustrates the benefits of adequate analysis. Commission analysts met with utility personnel to discuss costs of that utility's projects and inspected several project sites. As a result, commission staff identified cost reductions of approximately $7.4 million for two projects.

Financial Records

We also found that commission auditors did not always perform the most important tasks required in their examination of the utilities' financial records. Specifically, audit programs for the two general rate cases we reviewed did not include tasks to verify that amounts are recorded in the proper accounting period. In addition, commission auditors did not always complete audit steps to identify nonroutine expenses, to verify the proper classification of accounts, or to ensure that obsolete equipment was removed from the utility's rate base.

In their audit for the Southern California Gas Company general rate case, audit staff did not have procedures necessary to determine if production, distribution, transmission, or marketing expenses were properly recorded in the correct utility accounts. Further, for the Southern California Gas Company general rate case the audit staff did not review administrative and general or customer accounts expenses to identify nonrecurring items. These items must be identified so that nonrecurring items are not included in engineering forecasts. Further, we found that the audit reports to the commissioners do not disclose when reviews are limited in this manner.

If necessary audit steps are not completed, commission engineers must depend upon unverified data to calculate utility revenue requirements. The failure of commission auditors to investigate necessary items during their examination may result in use of incorrect data being used to calculate the revenue requirement that in turn is the basis for setting rates charged to consumers.

Routine Expenses For Operations and Maintenance Not Analyzed Thoroughly

We also found that the commission staff do not thoroughly analyze expenses for utility operations and maintenance. In the two general rate cases we reviewed, operations and maintenance expenses were among the largest expenses for utilities, amounting to over $3.6 billion. Although the commission staff analyzed nonroutine expenses for the two general rate cases we reviewed, they did not thoroughly analyze the routine expenses. Neither the auditors nor the engineers thoroughly determined the reasonableness of the costs upon which are based the projected expenditures for routine operations and maintenance. As a result, the commission cannot be certain that the projected costs for utility operations and maintenance are reasonable.

Commission staff analyze two categories of utility operations and maintenance expenses: routine and nonroutine.

Routine expenses are the normal, ongoing expenses that the utility has incurred over a number of years. For instance, the cost of labor and other expenses normally needed to maintain equipment are routine expenses. Costs that are of a special or nonrecurring nature are considered nonroutine. Nonroutine expenses could include expenses resulting from storm damage or chemical spills, or from new programs, such as the initial operation and maintenance of a new hydroelectric plant.

Utilities estimate their future routine operations and maintenance expense based on the recorded costs of their past operations. Yet, the commission staff do not thoroughly assess the reasonableness of these recorded costs. Instead, staff members review the utility's method for projecting future costs, and if the projection method is acceptable, the staff usually accept the estimated costs. However, according to staff engineers, unless the staff analyzes the utilities' routine expenses, commission staff will probably not discover if the utility's recorded costs has consistently included inflated expenditures or excessive staff.

We found examples that indicate that increased staff analysis of expenses for routine operations and maintenance would reduce utility requests and thereby help to assure that consumers pay only reasonable costs. For example, in the San Diego Gas and Electric Company general rate case, the staff

determined through a field trip that maintenance costs for gas mains were declining because the utility was replacing cast iron pipes with low maintenance polyethylene pipes. This finding resulted in a staff estimate of expenses for maintenance approximately $243,000 lower than the utility had claimed. In the same case, the staff used a performance measure that was based on hours of labor per tree to determine tree trimming costs. The staff noted that the cost of the utility's tree trimming program had increased 127 percent from 1975 to 1980, while the number of trees to be trimmed had increased only 10.3 percent and productivity had declined 37.5 percent. As a result, the staff estimated reasonable costs based on productivity attained by the utility from 1975 to 1979. This analysis resulted in a staff recommendation disallowing $1.1 million (33 percent) of the utility's projected cost of its tree trimming program.

The commission staff agreed that their limited analysis of routine operations and maintenance expenses may not ensure that utility expenditures are reasonable. But they said that staffing limitations make more detailed reviews impractical. Nevertheless, we believe that although a complete review of operations and maintenance expenses may not be practical during every rate case, increased staff use of site

visits and performance measures could enable the commission staff to complete a more thorough analysis of operations and maintenance costs.

THE COMMISSION STAFF ANALYSES ARE INCONSISTENT

The commission staff do not analyze utility requests for rate changes in a consistent manner. We found instances where engineers and auditors were inconsistent in their review and analysis of utility data. Commission engineers applied inflation factor adjustments to one utility's rate base but did not do the same for another utility. Commission auditors examined one utility's financial records but failed to do so for another utility. As a result of inconsistent review and analysis, the commission is not ensuring proper utility rates for all consumers.

Inflation Factor Not Applied Consistently

The commission staff were inconsistent in their assessment of utilities' use of inflation factors. In an application for rate increases, utilities estimate the increase in their nonlabor costs that will result from inflation. The commission staff assess the projected increase and lower the increase if they feel the utility's inflation factor is too high. In the general rate case for Southern California Gas

Company, the staff recommended lower inflation factors than those proposed by the utility. The staff made corresponding reductions to the utility's rate base because of the lower inflation factors and recommended that the utility's rate base for 1983 be reduced by over $45 million.

In the Pacific Gas and Electric Company case, the utility proposed that an inflation factor of 12.5 percent be used to estimate the increase in nonlabor costs for 1982. In contrast, the commission staff proposed an inflation factor of 10.7 percent. However, the staff failed to apply the reduced inflation factor to the estimated cost of additions to plant. Moreover, the commissioners subsequently adopted an inflation factor of 9.15 percent.

We estimate that the rate base for PG&E could have been reduced by at least $8.2 million if the commission staff had applied the inflation factor adopted by the commissioners. Since rates are based on the utility's rate base, the commission unnecessarily allowed PG&E to charge consumers inappropriate rates. Based on information provided to us by commission staff, we estimate that an inappropriate addition of $8.2 million to a utility's rate base could result in overcharges to consumers of up to $1.9 million per year.

Audits Not Consistently Performed

Another example of inconsistent review on the part of commission staff occurred in 1982 in fuel cost adjustment cases of two utilities that supply natural gas. The commission audited Southern California Gas Company but did not audit the gas department of Pacific Gas and Electric Company. The objective of these audits is to determine if the utility has presented fairly the data on the cost of gas, quantities of gas purchased, and gas sales revenues. Without an audit, there is a potential that gas costs and revenues reported by a utility may be in error and that consumers may pay inappropriate rates. On the other hand, an audit can result in recommendations of lower rates than those proposed by the utility. For example, as a result of the audit of Southern California Gas Company, commission auditors recommended that the total income requested by the utility be reduced by nearly $102 million.

While the commission has conducted audits in connection with fuel cost adjustment cases for electric utilities, the commission has not regularly conducted audits in conjunction with fuel cost adjustment proceedings for gas utilities. The commission has no written guidelines to determine when audits should be conducted for gas utilities in fuel cost adjustment proceedings. According to an audit supervisor, fuel cost adjustment proceedings for gas utilities

are less complex than fuel cost adjustment proceedings for electric utilities. Fuel cost adjustment proceedings for electric utilities involve issues such as various sources and uses of oil, gas, and nuclear fuels, while gas cases involve only the one fuel, which is bought mainly under long-term contracts at prices set by the federal government.

The commission's audit supervisors said that the commission will audit gas utilities if they identify special issues other than items usually considered in gas utility fuel cost adjustment cases. In the case of Southern California Gas Company, which the commission did audit, the auditors had previously identified several special issues such as disallowed gas costs and uncollectible expenses. In the case of Pacific Gas and Electric Company, auditors indicated that they did not identify any special issues and therefore did not audit the company's gas department.

The audit supervisors said that the commission should conduct audits of gas utilities in fuel cost adjustment cases, just as the commission does for electric utilities. The audit supervisors said that they are attempting to conduct audits in fuel cost adjustment cases for gas utilities in 1983.

THE COMMISSION STAFF RESPONSIBILITIES ARE NOT ADEQUATELY COORDINATED

Our review revealed that project managers have failed to coordinate staff activities adequately to ensure that staff perform their work efficiently. Project managers are responsible for ensuring proper handling of all elements in a rate proceeding and delineating the responsibilities of staff assigned to a case. However, engineers and auditors do not always follow their assigned responsibilities. As a result, in some cases the engineers and auditors have duplicated each other's work and, in other cases, have failed to perform necessary analyses. In addition, because the commission does not have a standard application form for utilities to supply data in fuel cost adjustment cases, engineers and auditors have separately requested the same information from the utilities.

Duplication of Effort

The staff of the commission's Revenue Requirements Division and the Utilities Division are responsible for analyzing different aspects of the fuel cost adjustment requests. Auditors in the Revenue Requirements Division are responsible for verifying actual expenditures and analyzing the reasonableness of recorded fuel costs. Engineers in the Utilities Division are responsible for evaluating the prudency of the utility's operations for the previous year and for

preparing forecasts of sales, prices, and fuel sources needed for the following year. A project manager from one of the divisions directs and coordinates staff activities. However, in two of the four fuel cost adjustment cases for electric utilities we reviewed, project managers did not adequately coordinate staff activities, and duplication of effort resulted.

In the Southern California Edison Company case, both engineers and auditors examined the reasonableness of recorded fuel costs and presented virtually identical conclusions to the commissioners. In the San Diego Gas and Electric Company case, both engineers and auditors analyzed the distribution of costs between consumers and stockholders for fuel oil held in inventory that exceeds the commission's allowed levels. In this instance, each group made a different recommendation to the commissioners. According to a division director, it is sometimes necessary to have different groups analyze the same issue to present different viewpoints to the commissioners.

Engineering and auditing staff also duplicated each other's work in requesting identical information from the utilities. We reviewed data requests in fuel cost adjustment cases for Southern California Edison Company, Pacific Gas and

Electric Company, and San Diego Gas and Electric Company, and found many instances of duplication.

Engineers made 107 requests for data to the three companies while auditors made 81 requests. Of the 188 requests, 60 were for the same information. For example, in the Southern California Edison Company case, both engineers and auditors requested information on the operating capacity of the company's coal plants.

Commission staff say that at times engineers and auditors need the same information in different formats. For example, engineers may need to look at the use of fuel, while auditors need information on the costs of that fuel. Staff also acknowledge, however, that one of the responsibilities of the project manager is to coordinate the data requests to avoid duplication and that this coordination has not always occurred.

Incomplete Analyses

While inadequate coordination of staff responsibilities leads, at times, to duplication of effort, at other times the result is no effort at all. For example, in the San Diego Gas and Electric Company fuel cost adjustment case, the staff failed to analyze several elements. Although the project manager had delineated duties, the staff did not

adhere to the separate responsibilities set forth by the manager. As a result, neither engineers nor auditors performed the necessary analysis of three items related to the reasonableness of the utility's management of fuel resources for the previous year. The staff failed, for example, to determine whether the natural gas available to the utility was used to generate electricity in the most economical manner. Because the staff had not analyzed this and other such items, the commission could not be certain whether the utility had made optimum use of available fuel resources.

While none of the three items was associated with specific fuel costs, they, along with other items, are indicators of the utilities' fuel management practices and they allow the commission to reach conclusions on the reasonableness of the utilities' operations for the previous year. If the staff were to discover that a utility had operated in an unreasonable manner, that finding could result in the commission's adjustment of the rate change requested by the utility. Without complete review of all elements in a rate change case, inappropriate costs caused by the utility's poor fuel management practices may be passed on to consumers.

Lack of Standard Application Form

While duplication of effort by engineers and auditors results from inadequate coordination by the project managers and failure of staff to adhere to their assigned responsibilities, duplicate requests for data from the utilities may result, in part, from the fact that the commission does not have a standard application form for fuel cost adjustment cases. Consequently, a utility's application may not provide all the data that staff need to conduct their analyses. We found that in fuel cost adjustment cases, engineers may request the same additional data from the utilities. In the fuel cost adjustment cases for electric utilities that we reviewed, the staff engineers requested that each utility provide information on estimated and actual fuel use. If this information had been requested in a standard application form, the commission would not have had to request it separately.

Moreover, lack of a standard application form may result in the necessity to request the same kind of additional information from the same company in successive years. For example, the same information on fuel use was requested from Sierra Pacific Power Company for two consecutive years.

The commission has recognized the need for requiring utilities to submit data in a standard format and at regular intervals. Commission staff and utility representatives have developed a draft form to collect information on fuels and operations from utility companies on a monthly basis. However, we found that several items that were requested in the fuel cost adjustment cases for the four electric utilities we reviewed were not included on this draft form.

According to commission staff, there is also a need for a centralized system to maintain the data collected from all cases. This system would enable staff to operate more efficiently by having some of the information they need readily available, thereby reducing the number of requests for additional data from the utilities. Such a system would allow the commission to monitor utility operations continuously, compare utility financial data, and track the processing of rate cases. Currently, the commission has partially implemented a data base management system and has plans to implement a rate case management system.

THE COMMISSION LACKS STANDARD PROCEDURES AND ADEQUATE STAFFING DATA

The commission lacks written standard procedures and policies to direct staff reviews. Also, certain supervisors do not adequately review staff work. Further, the commission

lacks adequate workload data for determining staffing needs. Absence of standard management systems and procedures contribute to incomplete and inconsistent reviews of utilities' requests for rate changes and in lack of assurance that the commission's decisions on utility rates are based on accurate information.

Lack of Standard Procedures

Our review of 10 recent rate cases revealed a general absence of written policies and procedures to specify the objectives of rate reviews, the issues that should receive priority during rate reviews, and the methods that staff should use in conducting the reviews. We also found that some supervisors fail to review staff work for accuracy and completeness. According to commission staff, standard practices were used several years ago but most are out-of-date and not applicable to current rate issues. Standard practices would be valuable in guiding staff, but staff cannot develop these systems because rate case workload demands take all available staff time. In addition, the most capable staff would be needed to develop these procedures.

Standard procedures could specify a systematic approach for reviewing project costs in a general rate case when a complete review of major projects is not possible

because of time or staff limitations. Currently, the extent of the review and the number of projects analyzed varies according to the judgment and the experience of the staff engineers or analysts. Standard procedures could also provide acceptable analytical methods, such as the use of performance measurements, that would guide the review of routine expenses, or define an approach that would include analyzing a sample of the routine costs of operations and maintenance so that all of these routine costs could be reviewed over several rate cases for a single utility. Commission policy and procedures regarding audits would also indicate when audits are required and would ensure that staff complete the most important steps in an audit first. Further, a policy requiring supervisory review of staff work could ensure that the commission's recommended changes, such as changes in the inflation factors in the Pacific Gas and Electric Company general rate case, are indeed applied to relevant costs.

Some commission staff claim that standard procedures are not practical because each rate case requires analyses of different issues. We found, however, that staff do use common approaches and do review standard items in preparing their rate review reports. Furthermore, outside consultants, in other studies of the commission, have also identified the need for standard procedures.

In 1976, the management consulting firm of Cresap, McCormick and Paget, Inc., identified "a pressing need to revise the standard operating practices for rate cases on the basis of the common elements in these studies and a unified approach." The firm went on to say: "In all Commission work, an effort should be made to develop common approaches and methodologies for analyzing company operations and preparing staff reports." Another report, prepared in 1981 at the request of the commission by Energy and Resource Consultants, Inc., suggested that fuel cost adjustment data and information for electric fuel cost adjustment proceedings should be provided in a standardized format by all utilities. The use of standard format would facilitate the commission's tracking of fuel procurement activities from year to year and facilitate the comparing of the activities of the four major regulated utilities: Pacific Gas and Electric Company, Sierra Pacific Power Company, Southern California Edison Company, and San Diego Gas and Electric Company. Standardization could also reduce the staff time required to review the data.

The commission has initiated changes that will address some of the weaknesses we identified. For example, staff from the Utilities Division have developed draft standard procedures to guide engineering staff in reviewing fuel cost adjustment cases. These procedures define approaches, methodology, and priority areas. Additionally, the division,

in cooperation with utilities, developed a draft form for utilities to report data on monthly operations and fuel use.

Workload and Staffing Issues

During the last ten years, state regulatory commissions have experienced a significant change in the complexity of utility rate cases. By 1973, the oil embargo, inflation, environmental regulations, declining economies of scale and productivity for electric utilities, the high cost of investment capital and the correspondingly high cost of utility construction programs, fuel shortages and disruptions, and the general state of the nation's economy combined to increase the responsibilities and complexities of utility regulation.

The California Public Utilities Commission responded to these conditions by changing its methods for reviewing and approving utilities' requests for rate changes. One major change was the establishment of a rate case processing plan that required the commission to decide general rate case applications within one year of their submission. A second major change was the establishment of fuel cost adjustment procedures that were meant to provide more timely recovery of costs than provided by general rate cases.

The commission also consolidated two divisions in 1979. The reorganization concentrated some review functions and shortened the time requirements for processing rate change cases. Although the commission has augmented its staff on various occasions to respond to increased workload demands, the executive director and the project managers told us that additional staff are needed to ensure thorough and consistent reviews of rate change applications. Project managers indicated that additional staff could be used to monitor utility construction costs, review utility research and development costs, monitor large construction projects, analyze depreciation issues, and perform thorough audits of utilities' financial records. Since fiscal year 1979-80, the commission has requested 76 additional positions for gas and electric rate case reviews and has received approval to add 49 positions.

However, because the commission has not clearly and fully defined rate review tasks and minimum review requirements, and because it has not developed a time reporting system that is tied to these workload elements, it is unable to develop workload data and standards to use for staffing estimates. These standards will be necessary for the commission to justify requests for additional staff. Still, the commission could increase the productiveness of the current staff by standardization of procedures and more effective coordination of staff.

CHAPTER II

CONCLUSION AND RECOMMENDATIONS

The California Public Utilities Commission needs to strengthen its systems for analyzing utility requests for rate changes and for ensuring that costs included in rates are reasonable. Because the commission's current procedures do not ensure that the commission staff adequately analyze utility applications for rate changes, the commission may not be adequately protecting consumers from paying inappropriate rates.

The commission does not ensure that utility applications for rate changes are thoroughly analyzed. The commission staff did not analyze 44 of 61 projects each costing over $1 million that one utility requested be added to its rate base in 1982. Also, in the two general rate cases we reviewed, the commission staff did not thoroughly analyze the reasonableness of routine operations and maintenance expenses forecasted by the utility companies. Additionally, the staff did not always perform the most important tasks required in their audit of financial data in general rate cases. As a result, the staff may not have identified inappropriate costs that are included in the rates charged to consumers.

The commission does not have adequate management procedures for monitoring and controlling its staff to ensure that staff consistently complete all necessary tasks. We found that commission staff did not adjust the inflation factor used by one electric utility in estimating future expenses but did make this adjustment for another utility. Likewise, the staff audited one gas utility in a fuel cost adjustment case in 1982 but did not audit another gas utility in another fuel cost adjustment case during the same year.

The commission does not adequately ensure that staff responsibilities are coordinated. Commission engineers and auditors performed duplicate tasks, conducting the same analyses and requesting the same data in the review of a rate change request. Moreover, lack of coordination of staff resulted in the incomplete review of another utility's application for rate changes.

Finally, the commission lacks adequate workload data and defined staffing responsibilities needed to establish and justify appropriate staffing levels. Still, while inadequate staffing and increased workload demands may have contributed to the problems we have described, development of standard procedures and effective management systems to guide staff reviews would enable the commission to better fulfill its

responsibility to ensure that rates charged by California's privately-owned utilities are appropriate and fair.

RECOMMENDATIONS

To ensure that utility rates are fair and reasonable and that staff resources are used efficiently, the California Public Utilities Commission needs to define its policies and modify its procedures for analyzing and auditing rate change applications. Specifically, the commission should do the following:

- Develop and follow standard work procedures for reviewing and analyzing requests for rate changes. These procedures should include standard analytical approaches for use by commission staff in assessing the costs of additions to plant, the expenses for operations and maintenance, and other major elements of a utility rate change request. The procedures should define the objectives of the review, establish work priorities, and clarify responsibilities of the engineers, auditors, and analysts.

- Develop a standard form for utilities to use in submitting their rate change requests. The standard form should fully describe the data that the

commission needs to process the request and the format in which the data should be submitted. The commission should also fully implement the data base and case management systems to review utility operations and track rate cases.

- Establish and follow procedures for management review and quality control to ensure thorough, complete, and consistent analyses of utility requests for rate changes. These procedures should coordinate project teams, ensure consistency in analysis of rate change applications, and improve the quality of staff reports.

- Develop workload data and staffing standards for all elements of the rate change review. The commission should use the data to establish appropriate staffing levels for each division and to support requests for additional staff.

We conducted this audit under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specifically contained in the audit request.

Respectfully submitted,

THOMAS W. HAYES
Auditor General

Date: May 31, 1983

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Public Utilities Commission

STATE OF CALIFORNIA

FILE NO.

May 23, 1983

Thomas W. Hayes, Auditor General
660 "J" Street, Suite 300
Sacramento, CA 95814

Dear Mr. Hayes:

You have asked for our comments on the report entitled "The California Public Utilities Commission Needs to Improve Its Rate Review Systems". The extremely short time allowed us does not permit a formal Commission response and the comments that follow are those of Commission's staff.

We agree that all agencies of California government should constantly strive to do the best job they possibly can. We therefore welcome reviews of our procedures that will help us work toward that goal. Your report recognizes that many of the things you suggest are things we are already doing.

Unfortunately, however, the report suffers from an absence of perspective. It fails to recognize the nationwide reputation of the California PUC staff for skillful, innovative work. It fails to include the recognition, which your audit team communicated to us informally, that the PUC staff has an extremely difficult and complex job. Rather, the report concentrates on only a few areas, and may thus allow readers to come to erroneous conclusions about PUC staff work. This can only encourage those whose solution to high utility rates is to shoot the messenger.1/*

In short, while we agree with the purpose of your report, to help us achieve top-quality staff work, we don't agree with all of the ways you have applied your general principles to our operations.

Specifically:

-- The report says the staff could more thoroughly review utility power plant expenses through "increased staff use of site visits." We agree. But the report unaccountably fails to point out the reason for fewer site visits: Because of the state's financial condition, our budget for staff travel has been greatly reduced.2/

* The Auditor General's comments on specific points contained in the commission's response begin on page 42.

-- The report says staff reviews would be improved if we had more financial examiners and other staff experts. We agree. But the report says the PUC lacks "workload data and staffing standards" necessary to justify more staff. We disagree completely. We believe we have more than adequate data. But in any event, the report should unequivocally make clear that additional staff will be needed to do additional work.3/

-- The report criticizes the staff for apparently failing to audit every account of every utility. True, we don't, any more than any other auditing agency is ever staffed to audit every account (for example, the Franchise Tax Board doesn't audit every taxpayer). But the report fails to point out that we assign our top financial examiners to the issues with the greatest potential impact on utility rates, and that we spot check the others. Spot-checking is a technique used by all auditing agencies, and is, of course, the technique used in your review of our work.4/

-- The report says that the absence of total auditing means the Commission "may" not be able to protect ratepayers adequately. But staff auditing of utility applications is not the only means of protecting ratepayers. For example, the staff also has a monthly reporting system to monitor utility earnings, to insure that no utility is earning more than the Commission has authorized.5/

-- The report urges more emphasis on standardized procedures and standardized application forms. We agree that where such procedures and forms are appropriate, we should use them, and we do. But the report fails to note the high cost of writing procedures and manuals. And the report fails to point out that the last several years have seen great volatility in fuel costs--from rapidly-rising oil prices and high inflation, for example, to falling oil prices and lower inflation rates. Surely it would be poor management in such changing times to take our most talented people away from

direct analysis of fuel costs and set them to writing procedural manuals. Rather, we have put our emphasis on devising procedures necessary to meet new conditions. If stability returns to fuel costs, we agree that standardized procedures will be of greater value.6/

-- The report says that inadequate staff supervision has sometimes led to duplicate data requests to utilities, and to duplication of staff work. To the extent this is true, we've moved to correct it. Inevitably, as we've adapted our procedures to changing world energy conditions, we may not have had perfect efficiency in our operations. But it is by no means duplication that an auditor and an engineer may both be examining utility information: the auditor is examining financial aspects of the company's application, and the engineer the efficiency of the company's operations. Moreover, our basic operations increasingly use staff project teams, under the direct supervision of a top-level project manager, to bring together the skills of accountants, auditors, attorneys, economists, engineers, and other staff specialists.7/

In summary, we agree that our staff review of all utility applications should be as thorough and detailed as we can make it. We try constantly to do this. We regret, however, that your report focuses so narrowly on a few aspects of our work and that it omits all mention of the tenacious, dedicated work of many of our staff members during a time of unprecedented change in the utilities the Commission regulates.

Yours very truly,

Joseph E. Bodovitz

JOSEPH E. BODOVITZ
Executive Director

AUDITOR GENERAL'S COMMENTS ON THE CALIFORNIA PUBLIC UTILITIES COMMISSION'S RESPONSE

1/ The commission's response states that readers of our report may reach erroneous conclusions about the work performed by commission staff because our report "concentrates on only a few areas." In fact, our review was a comprehensive analysis of the staff work performed on 10 separate gas and electric utility rate change applications. Our methodology included a thorough review of the rate case documents, reports, and workpapers, and extensive interviews with management and staff. Consequently, our conclusions about the weaknesses in commission staff work are thoroughly documented by sufficient evidence collected in accordance with generally accepted governmental auditing standards.

2/ On page 12 of the report, we acknowledge that budget restrictions have limited staff visits to project sites. However, we found that budget restrictions were not the only reason for limited staff visits. In several instances, for example, commission staff believed that the utility was proficient at estimating project costs and there was no need to verify the estimates by visiting project sites.

3/ We do not conclude that additional staffing would improve the thoroughness and consistency of commission rate reviews. We could not determine if additional staff are needed because the commission lacks adequate workload data and staffing standards to assess its staffing needs. Although the commission believes that such data exist, we found the available information inadequate for determining staffing requirements. The commission's data consist of one manager's estimate of the number of staff needed to perform a list of vaguely defined tasks. We believe that workload data should include, at a minimum, defined work tasks, specific workload objectives, and measures of the actual staff time needed to accomplish those tasks and objectives. The commission's data lack these elements.

4/ Our report does not suggest that the commission audit every account of every utility. On the contrary, we state on pages 28 and 29 that the commission should specify a systematic approach for reviewing rate cases, including analyzing a sample of costs when a complete review is not practical because of time and staffing limitations.

Although the commission's response states that this "spot-checking" is used, our review revealed a general absence of written policies and procedures that specify how "spot-checking" should be employed, the issues that should receive high priority, and the methods that staff should use in conducting the reviews. Furthermore, we found that the commission's auditors often failed to complete reviews of those issues with the greatest potential impact on utility rates.

5/ The commission's response states that the commission utilizes a monthly reporting system to monitor utility earnings. However, it is not clear how a monthly report will ensure that utilities earn no more than authorized by the commission. Utility rates can only be adjusted through a rate review.

6/ The commission's response that "it would be poor management...to take our most talented people away from direct analysis of fuel costs and set them to writing procedural manuals" is inconsistent with the commission's own management actions. For example, one of the few units that has begun preparing a standard practices and procedures manual is the Fuels and Operations Branch, which is responsible for reviewing rates for fuel adjustment costs. Furthermore, in an environment of changing conditions, standard procedures need not be static; they can and should be modified in response to new circumstances. In addition, with the exception of audit plans, the commission lacks current standardized procedures in most areas of the rate review process. Although the commission's response indicates that standard procedures are used where appropriate, we found no evidence that the commission practices this policy.

7/ On page 22, we state that auditors and engineers have specific responsibilities for reviewing different aspects of a utility's operation. However, in some cases, we found that staff duplicate their efforts by reviewing and analyzing the same data and preparing staff reports on the same issues. In addition, while the use of project teams is an important tool to promote coordination of staff use, we found that most instances of duplication occur under this project management system. For example, in our review of fuel cost adjustment cases, we found 60 duplicate requests for utility fuel cost information.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Director of Finance
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps